Chapter 5 Pakistan's Choice-Analysis from Economic Perspective

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Chapter 5

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Pressed by the United States for cooperation in the fight against terrorism, Pakistan pledged full support. Pakistan has the 1,200-kilometer-long border with Afghanistan and its government had been believed to be very close to the Taliban regime, which harbors Osama Bin Ladin, prime suspect of the terrorist attacks on September 11. Behind Pakistan's prompt compliance with the U.S. request for cooperation in the retaliatory military action reflects its diplomatic concern that if Islamabad had turned down the U.S. request, it would be branded a state supportive of international terrorism and would be isolated in the international community. More importantly, there was a paramount economic reason that Pakistan would find it very difficult to revive its stagnant and debt-strapped economy without assistance from the Untied States and other Western donors. Given the economic cost of its refusal to accept the U.S. demand, it is apparent that Pakistan really had no choice but to cooperate with the United States.

This chapter will review the Pakistani economy in the 1990s onward to examine the economic factors behind Pakistan's choice, and also look at Pakistan's current situation by focusing on its external debts and problems involved.[29]

5. 1 Economic Situation in the 1990s

5. 1. 1 Pakistan's Slumping Economy

In the decade after the independence in 1947, when Pakistan had little industrial foundation, its real GDP growth rate had been low at an annual average of 2.9%. Momentum picked up, however, when Ayub Khan, the first military ruler, presided over the nation from 1958 to 1968. Real GDP growth accelerated to 6.8% during the 1960s. Industrialization started and the Green revolution resulted in improved productivity in the agricultural sector. Though economic downturn was observed during the Bhutto era in the 1970s, overall the economy grew 5.7% per annum on average for the 30 years from the beginning of the Ayub regime to the end of Zia ul- Haq's military government. Particularly the Pakistani economy achieved the high average growth of 6.7 % annually under the Zia military regime (see Table 1).

In August 1988, after Zia was killed in a plane crash, democracy was restored in Pakistan. During the 11-year period until a military coup d'etat in October 1999, Benazir Bhutto of the Pakistan People's Party (PPP) and Muhammad Nawaz Sharif of the Pakistan Muslim League (PML) each assumed premiership twice. During this period, Pakistan tried to introduce policies guided by economic liberalization under structural adjustment programs of the International Monetary Fund

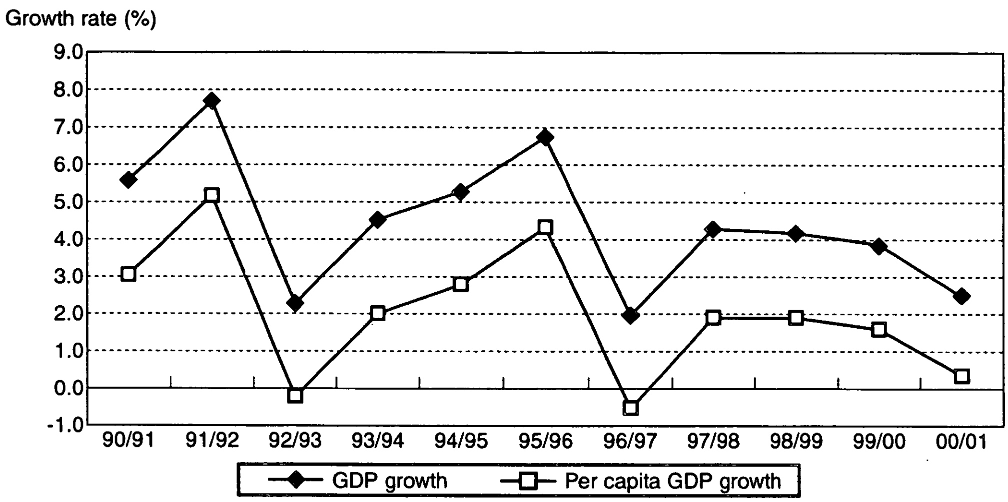
Table 1 Economic Growth under Different Political Regimes (annual average %)

	Independence/ Democracy	Military Regimes (Ayub Khan & Yahya Khan)	Civilian Dictatorship (Bhutto)	Military Regime (Zia)	Parliamentary Democracy
	1947-1958	1958-1971	1972-1977	1977-1988	1988-1999
GDP growth	2.9	5.3	5.4	6.7	4.1
Population growth	2.5*	2.2	3.2	2.8	2.5
Per capita GDP growth	0.4	3.1	2.2	3.9	1.6

Sources: Burki (1999), *Pakistan: Fifty Years of Nationhood*, p. 103, Table 3.4, and prepared by the author from data in issues of Government of Pakistan, *Economic Survey*.

*Figures for 1950-1958

Figure 1 Growth Rates in the 1990s



Source: Prepared by the author from data in Government of Pakistan, *Economic Survey 2000/01.*

(IMF). But the country's economic performance in the 1990s was far from satisfactory. President Musharraf, who took over the reins of government in the October 1999 coup, put economic rehabilitation at the top of his policy agenda and introduced a number of reform measures. He can take credit for fiscal deficit reductions, growth of exports and the crackdown on corruption. But the serious drought brought extensive damage to Pakistan's agricultural sector in fiscal 2000-2001, bringing the GDP growth rate down to a disappointing 2.6%.

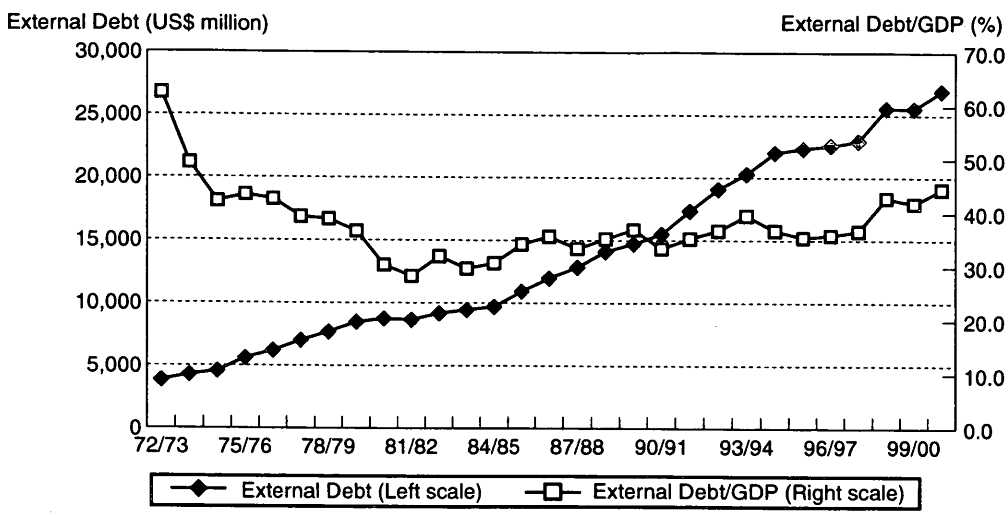
The average annual GDP growth rate came to 4.0% between fiscal 1990-1991 and 2000-2001, over 2 percentage points lower than the average growth achieved under the Zia military regime. In the most recent five years in particular, the Pakistani economy had been sluggish with the average annual growth of 2.9% (see Figure 1). In terms of per capita GDP, the growth was the exceptionally low at 0.34%. Poverty spread as a consequence. People living below the poverty line accounted for 23.3% of the total population in fiscal 1990-1991. But a report[30] showed the ratio rose to an estimated 30% in fiscal 2000-2001.

Aside from the poor performance of the agricultural sector damaged by the drought and the insect plague, the low economic growth may be blamed on the political instability in Pakistan, where eight governments, including four interim ones, were installed between 1988 and the military coup in 1999. During this period, neither Benazir nor Nawaz completed its 5-year tenure. Under these political circumstances, the Pakistani economy suffered from frequent changes of policy and system, making economic activities under long-term planning difficult. It also was impossible to address structural problems under a short-lived government, including macroeconomic imbalances that had worsened in the last years of the Zia regime. Such political instability apparently was a major factor behind the prolonged economic slump since 1988. The deteriorating law and order in Sindh province, where the commercial city of Karachi is located, due to religious and ethnic conflicts, and the alienation of investors by the protracted dispute over independent power producers (IPPs)[31] also dampened economic activities. In the aftermath of the nuclear testing in May 1998, the added blow to the Pakistani economy came in the form of economic sanctions by the United States, Japan and other countries as well as the freezes on lending by international financial organizations including the IMF.

5. 1. 2 Ever-Increasing External Debts

One of the snags in the Pakistani economy is the colossal amount of external debts. The fiscal deficits that accumulated over long years and the dependence on foreign assistance for development

Figure 2 External Debts



Source: Prepared by the author from data in Government of Pakistan, *Economic Survey 2000/01*.

funds caused Pakistan's external debts to increase year by year. For Pakistan with scarce foreign exchange reserves, servicing the bloated external debts unbearably narrows policy options of the government.

Foreign financial assistance to Pakistan used to have the high ratio of grant elements. But the ratio of grant aid gradually declined, and financial aid from overseas piled up as the country's external obligations. The ratio of grant aid was nearly 80% under the first five-year economic program (1955-1960), but dropped to 46% under the second five-year program (1960-1965), and to as low as 9% under the eighth program (1993-1998). Consequently, Pakistan's external debts (medium- and long-term public debts) expanded to $26,889 million, or 44.3% of GDP, in fiscal 2000-2001 from $1,021 million, or about 18% of GDP, in 1964-1965 (see Figure 2). During the 1990s, the growth of external debts surpassed the rate of economic growth, creating the remarkable imbalance between external debts and economic growth.

According to a report by the Debt Management Committee of the Pakistani government, the combined amount of medium- and long-term external debts and other external obligations

Table 2 Breakdown of Pakistan's External Debts

External debt (US$ billion)				36.5
Breakdown	Bilateral Donors			12.5
		Japan	5.0	
		U.S.A.	3.1	
		France	1.3	
		Germany	1.1	
		S. Korea	0.7	
		Canada	0.4	
	International Financial Institutions			15.5
		World Bank Group	7.0	
		Asian Development Bank	6.5	
		IMF	1.6	
	Others			8.5

Source: *Dawn*, September 26, 2001.

including short-term borrowings and foreign currency deposits comes to $36.5 billion to top the ratio of 50% to the country's GDP (see Table 2 for the breakdown). The World Bank group is the biggest creditor among international institutions, while Japan is the largest creditor among bilateral donors, with outstanding claims of some $7 billion and $5 billion, respectively.

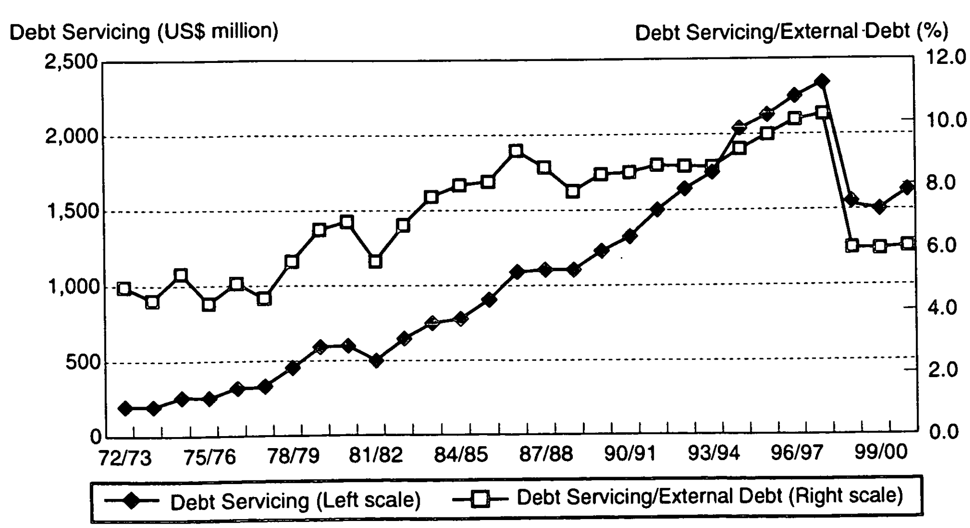
5. 2 External Debt Servicing and IMF

5. 2. 1 Heavy Burden of External Debt Servicing

Pakistan has been running chronic trade deficits, and its foreign exchange reserves are at a low level. In the meantime, with absolute amounts of principal and interest payments rising each year, external debt servicing is proving a major burden on the Pakistani government (see Figure 3). Around the autumn of 1998, Pakistan's exchange reserves plunged to a level equivalent to about two weeks' imports, sending the country to the brink of international default. Debt repayment difficulties came to a head already in the first half of the 1970s, forcing Pakistan to reschedule its external debts twice, in 1972 and again in 1974. Since the mid-1970s, however, Pakistan had an inflow of foreign currencies in various forms, and used them to repay debts and make up for international balance of payments deficit, putting off taking fundamental steps to solve the balance of payments problems.

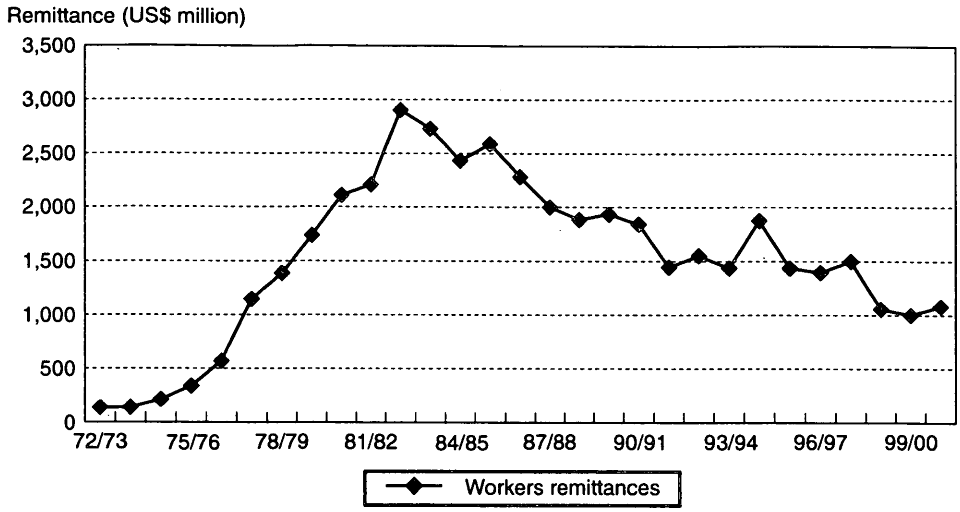
From the mid-1970s through the 1980s, the sharp rise in remittances from Pakistani nationals working in the Middle East was instrumental in covering the balance of payments gap. The total amount of remittances exceeded the value of exports in 1982-1983 and 1983-1984 (see Figure 4). While remittances from overseas peaked in fiscal 1982-1983, the new source of hard currencies came in the form of military and economic assistance from the United States following the Soviet invasion of Afghanistan. The Reagan administration provided $3.2 billion in aid in the five years from 1981, and pledged an additional $4 billion in 1986. The U.S. assistance was suspended in 1990 following the Soviet withdrawal from Afghanistan. In the early 1990s, the government of Prime Minister Nawaz Sharif allowed resident Pakistanis to open foreign currency accounts as part of the financial market liberalization, creating a system of siphoning foreign currencies in the private sector. In the mid-1990s, the balance of payments gap was also covered by foreign direct investment in privatized electric power businesses as well as by foreign cur-

Figure 3 External Debt Servicing



Source: Prepared by the author from data in Government of Pakistan, *Economic Survey 2000/01*.
Note: The sharp drop in external debt repayments and the ratio of repayments to total debts in 1998/99 is traced to the debt rescheduling by the Paris Club.

Figure 4 Workers Remittances



Source: Prepared by the author from data in Government of Pakistan, *Economic Survey 2000/01*.

rencies acquired through the partial transfer of equity shares in Pakistan Telecommunications Corporation(PTC). During this period, Pakistan continued to register trade deficits. Pakistan has never reported an annual trade surplus since fiscal 1972-1973. In short, Pakistan kept making ends meet in the balance of payments by compensating for its inability to earn sufficient foreign currencies through unsustainable methods. Since the nuclear tests, these methods were no longer operative. Currently, Pakistan finds it extremely difficult to service its external debts without assistance from the IMF and subsequent external debts rescheduling approved by the Paris Club[32].

In addition to the difficulty raising necessary foreign currencies, external debt repayments are imposing severe fiscal constraints on Pakistan. Of the total government expenditures of 701.9 billion rupees for fiscal 2000-2001, 316.1 billion rupees were spent on domestic and external debts servicing. Of the debt servicing, 40.7% were for honoring external debts, or about 20% of the total expenditures. Military spending and debt servicing together accounted for 67.5% of the federal budget, leaving little money for development projects. The ratio of development budgets to GDP decreased to 3.0% in fiscal 1990-2000 from 9.3% in fiscal 1980-1981, raising fears about adverse effects on future economic growth.

5. 2. 2 IMF-Pakistan Relationship

Full assistance to Pakistan under the IMF structural program started after the death of Zia in 1988. In fiscal 1987-1988, Pakistan's budget deficit reached 8.5% of GDP, while the inflation rate rose to 10%. The decline in remittance from Pakistanis working in the Middle East and increased imports exacerbated the country's balance of payments problems. All these problems combined to destabilize Pakistan's economy, prompting the country to seek support from the IMF. On December 28, 1988, the Pakistani government signed an agreement with the IMF to introduce a $2.1 billion, three-year Structural Adjustment Facility (SAF). The program was later extended by one year, but ended without achieving objectives.

Pakistan, under the second Sharif administration, then concluded a three-year Enhanced Structural Adjustment Facility(ESAF) accord for $1.56 billion, but this program was suspended following its nuclear tests in May 1998. In January 1999, IMF lending to Pakistan was resumed after the country was driven toward default amid the plunging foreign exchange reserves. The Paris Club also approved the rescheduling of $3.2 billion in official debts. In May 1999, however, the IMF lending was again suspended due to Pakistan's failure to honor conditionalities attached to loans. The Musharraf government and the IMF started negotiations on the resumption of lending in January

2000, and on November 29, 2000, the IMF's Executive Board approved a Stand By Arrangement (SBA) of $596 million for a period of 10 months. The accord with the IMF paved the way for Pakistan to receive loans from the World Bank and the Asian Development Bank, while the Paris Club decided to reschedule debt repayments in arrears as of the end of November 2000 and debts worth $1.8 billion falling due between December 1, 2000, and September 30, 2001. On September 26, 2001, the last tranche of the SBA was approved, allowing Pakistan to complete the 10-month program. It was the first time that Pakistan completed the IMF program within the prescribed period, an achievement of significance in terms of winning back the trust of the IMF.

The terrorist attacks on the United States happened at a crucial moment for Pakistan's economy. The attacks came just as the SBA to Pakistan was all but completed, and Pakistan and the IMF began talks on the medium-term Poverty Reduction and Growth Facility (PRGF). The three-year IMF program is linked with debt rescheduling by the Paris Club as well as lending programs of the World Bank and the Asian Development Bank. As these programs are of extreme importance for Pakistan's economic development as well as poverty reduction, it is fully understandable that Pakistan opted for strong support from the United States, which has a strong say on the IMF Executive Board. Considering that Pakistan really needed to smoothly shift from the SBA to the PRGF, it is quite apparent that Pakistan had no alternative other than accepting the U.S. request for military operations in the region.

5. 3 Economic Assistance to Pakistan and Future Prospects

5. 3. 1 Lifting of Sanctions and New IMF Program[33]

As Pakistan pledged to cooperate with the United States over the fight against terrorism, the Bush administration, as a first step, decided to remove military and economic sanctions imposed after the 1998 nuclear tests (see Materials 7 for U.S. sanctions against Pakistan). It also approved the rescheduling of $379 million in official U.S. credits, in line with the Paris Club decision of January 2001. The primary objective of the U.S. lifting sanctions was to reopen military assistance to Pakistan, which had been banned under the sanctions, with economic aspects of the decision only supplementary to the main purpose. Under the post-war like situation, the lifting of the sanctions is likely to have only limited effects on Pakistan's domestic economy in the short run, but it opens the way for U.S. and Pakistan business entities to gain access to trade insurance and credits provided by the U.S. Export Import Bank (EXIM Bank) and Overseas Private Investment Corporation (OPIC). In addition to the removal of the sanctions, the United States has decided to extend $ 1 billion support to the government of Pakistan, $600 million of which is direct budget support and it was already signed on November 15.

The Japanese government, meanwhile, decided to provide Pakistan with emergency assistance of $40 million ($14.5 million for the relief of Afghan refugees and $25.5 million in emergency budgetary aid). Also in line with the Paris Club accord of January 2001, Tokyo decided to reschedule $555 million in bilateral debt. Furthermore, on October 26, Japan suspended economic sanctions placed on India and Pakistan following their nuclear tests. Subsequently to this decision, on November 15, Japan's cabinet approved $300 million grants to Pakistan over the next two years.

On December 7, the IMF Executive Board approved a three-year Poverty Reduction and Growth Facility (PRGF) for Pakistan totaling $1.3 billion. The extension of the PRGF was considered a certainty even before the terrorist attacks, reflecting Pakistan's sound macroeconomic management and efforts implementing structural reforms under the last Stand-By Arrangement, but the lifting of the sanctions made the United States and Japan to actively endorse lending to Pakistan by the IMF.

With the approval of this new IMF program, Paris Club creditors, on December 13, 2001, agreed with Pakistan to a restructuring of Pakistan's public debt. The agreement provides for a comprehensive restructuring of a stock of debt amounting to $ 12.5 billion as of November 30, 2001, and allows Pakistan to save $2.7 billion over the next three years, freeing up resources for social sector expenditures and development projects. Unlike the previous two debt rescheduling agreements, which were based on Houston terms, debt servicing would reduce substantially under this new agreement.

Since debt servicing is a major burden to Pakistan as it eats around 40% of the federal budget, the debt relief, as it is expected, will provide a chance for Pakistan to get out of a debt trap and pave the way for economic revival.

5. 3. 2 Closing Remarks

When the Soviet Union invaded Afghanistan, the United States extended military and economic aid worth $7 billion to Pakistan. With the strategic importance of Pakistan reduced following the Soviet pullout from Afghanistan, however, Washington halted assistance and instead imposed sanctions over Pakistan's suspected nuclear program. During the 1980s, Pakistan under the Zia administration had achieved high economic growth, but the growth was not totally that of Pakistan's own making. The growth partly was a house of cards built precariously upon external assistance.[34] After the cutoff of U.S. aid, the economy slipped into sluggishness, and the 1990s was cynically described as the "lost decade." Many Pakistanis feel distrustful of the United States, which they think abandoned Pakistan with little strategic importance. But the Pakistani government is to blame for creating the "lost decade" by putting off necessary structural reforms of the economy for the duration of U.S. aid. The latest flows of U.S. assistance to Pakistan somewhat resemble the pattern of U.S. aid to the country in the 1980s. In order to avoid making the same mistake in the past, the Musharraf administration is being called upon to keep up with reform efforts to rebuild the sluggish Pakistani economy.

While Pakistan's self-help efforts are definitely needed, the international community's sustained assistance to Pakistan is all the more important. The overall effects caused by September 11 events on Pakistan's economy are hard to measure, but it is certain that the economic performance is shadowed by considerable uncertainty and is highly dependent on developments of political and diplomatic situations in the region. In this regard, it is hoped that the international community will provide continued support until the Pakistani economy regains it footing and the regional stability is restored.

(Hisaya ODA)

Notes:

29. Data used in this chapter are either quoted from or processed by the author as necessary on the basis of issues of Government of Pakistan, *Economic Survey*. Sources other than *Economic Survey* are specified as they are used.
30. Data are quoted from Government of Pakistan, *Interim Poverty Reduction Strategy Paper* (I-PRSP), (2001). With the poverty line set as the minimum intake of 2,150 kilocalories per day, the poor are defined as people who earn less than required to provide for the calorie level.
31. IPP problem: The second Bhutto government concluded electricity purchase contracts with independent power producers (IPPs), but the Sharif government unilaterally canceled them as "corrupt contracts," and urged IPPs to reduce power rates. Talks between the government and Hub Power Company, Ltd., the biggest of IPPs, dragged on, adversely affecting foreign direct investment in Pakistan.
32. The Paris Club is the group of official creditors, mostly OECD member states, which hold consultations on the rescheduling of external debts in arrears of debtor nations. Debt rescheduling granted by the Paris Club is conditioned on debtors' acceptance of IMF loan programs.
33. Developments regarding economic assistance are covered until December 31, 2001.
34. Other factors behind the economic growth of the 1980s include the consumption boom brought about by increased remittance from Pakistani workers in the Middle East.